International Outlook

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Protecting Your Foreign Investment!

By Lance Cannon, Manager FX Sales & Trading

From natural disasters to some European nations facing financial collapse, more and more companies are asking about net investment hedging strategies and whether they need to include them in their plans. We put together three true examples of companies that did or did not employ net investment hedging strategies and the consequences that followed.

Is My Company At Risk?

Recently, we were approached by one of our clients who are in the process of purchasing a new facility overseas and wanted to know how they could protect the value of this investment. This reminded us of a cautionary tale we witnessed with another company in the same situation, and the disastrous result of their ill-conceived decisions. This company created a unique technology product that saw skyrocketing demand. They decided to buy a huge overseas manufacturing facility and pay for it in cash! They paid around $1Billion for this facility, and were considering hedging the value of their investment with a currency hedge. Ultimately, the company decided not to hedge their Net investment in the facility. Soon thereafter, their technology became quickly outdated and they were faced with selling the facility in the middle of the dot com crisis. They ended up selling for pennies on the dollar, and to add insult to injury the currency had depreciated several times since their initial purchase. They recouped less than 10% of their total investment, and shuttered the business. Sadly, if they had simply hedged the currency aspect of their Net Investment their loss would have been less than 40%. In short the company would have ended up with an additional $500 Million in the bank, and may still be in business today.

What the company had originally considered, and subsequently rejected was a net investment hedge. This allows a company to protect their equity invested in a foreign subsidiary/operation from foreign exchange volatility. This effective strategy matches the net equity invested in the subsidiary with an off-setting derivative instrument. This derivative will allow you to mitigate the FX impact the equity investment can have on the parent's balance sheet.

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How does this work?

Let's take a look at a situation of a current client that GPS recently helped in hedging the net investment of their foreign operations.

The company has a large investment in their operations/subsidiary in the UK. This profitable company is constantly growing and actively engaged in mergers and acquisitions in Europe. They recently decided to leave their net operating income in the UK for future investment in materials, machinery and new acquisitions. Previously, all excess cash was repatriated back to the parent company in the U.S. With the current volatility in the currency markets and large debt structure of this entity, it was important for them to protect the asset value of their foreign investments.

GPS was approached to help them find a solution to protect their ongoing investments from currency volatility. This was an interesting situation as their net investment was growing on a continuing basis, and they did not want to settle hedges on a monthly basis.

GPS recommended that the company enter into a net investment hedge coinciding with their year-end. They expected that their Net Investment would continue to grow monthly and they needed a provision that would accommodate this. The decision was made that they would add to their existing position on a monthly basis, hedging out to the common year-end date. This allows the company to reflect the changes in the overall net investment in the subsidiary.

The strategy outlined above mitigates the impact that currency fluctuations can have on the net investment in the subsidiary. With our help, the treasurer of this company has taken control of the situation and will now show any changes due in the value of the net investment in CTA (cumulative translation account) account. Because the company had used the proper documentation they were able to receive hedge accounting. In the event that they had not prepared the proper documentation and thus not received hedge accounting, all changes in the value of the net investment would show in FX P/L.

With their net investment hedged the company can now focus on how to grow their foreign operations and continue to increase their presence overseas instead of worrying about how the foreign currency market has impacted their overall investment.

Here's another example.

We have another client that recently purchased a subsidiary in Europe. They were paying about $50 million in Euros for this new addition. When setting out to purchase this company, they borrowed the entire amount from a financial institution.

The plan was that the new subsidiary would be profitable, and repay the Net Investment and the loan back over a period of several years. One of the big concerns was that the subsidiary does all of their business in EUR, and the net investment exposure and loan are in USD. Another consideration was that the timing of the repayment of this loan was not perfectly clear as they were in the transition of ownership.

The parent entered into a Net Investment Hedge at the beginning of the loan, where they sold EUR and Bought USD to the end of the reporting year. At the end of year 1, the subsidiary had not been able to make any payments and the whole hedge was then swapped out and put back on the books for the following accounting year.

During the second year, the subsidiary started making payments on their loan. The first payment of 3 million Euros occurred half way through the accounting year. When the subsidiary made the payment they did a reverse swap for the portion of the loan that was being paid down, reducing the outstanding hedge by almost $4M. This allowed the company to get the original exchange rate, and eliminate worries about fluctuating currency rates.

Hedge accounting can be received with this type of hedge, assuming the proper documentation is used at the beginning of the hedge. This will allow any gains/losses due to the derivative (forward contract in most cases) being marked to market to be put in the CTA instead of FX P/L.

Summary

In each of these scenarios, the solution was simple and fairly straightforward. However, that may not always be the case; in some situations a more complex hedging strategy may be needed, in which case we recommend you speak with a FX Strategist at GPS. Regardless of your situation, you and the company will enjoy the benefits of understanding and implementing a strategy to cover the net investment in foreign subsidiaries.

Greece Update

Rioting in the streets, nationwide strikes and chaos rules the day as the reality of their financial situation filters down to the Greek populous. As the problems in Greece escalate the Euro is quickly losing its luster as a reserve currency. The Euro has lost 6% of its value against the USD, and 10% versus the JPY just since last week as money quickly flows into these two safe haven currencies.

Why the Riots?

The Greeks have been stunned that their government has taken steps to reform their spending and raise taxes to qualify for IMF backing of loans. The Greek government has pledged to cut government services, pension plan payments, and increase taxes. Unfortunately, it seems that most Greeks fail to understand the seriousness of the problem.

Is it Really that Bad?

Last week, the market for Greek debt achieved the lowest rating of any country in the world, surpassing Venezuela. Additionally, Greek Prime Minister George Papandreou announced that they will not be able to make their bond payments at the end of this month. If that happened and Greece was unable to borrow money, their only other option is for the country to declare Bankruptcy. If this happens, borrowing would be impossible and the government would have to rely 100% on their income to provide services to the people. If this were to happen, the austerity cuts would seem like nothing.

How does this impact the rest of the World?

Stock markets around the world have been rocked in anticipation of long reaching implications of the crisis in Greece. Expect uncertainty to continue until the EU decides what is more important, the current membership in the EUR, or the integrity of their financial guidelines. In short, expect uncertainty and volatility for the near future!